

April 4, 1980

**CHARITABLE TAX DEDUCTION
FOR NON-ITEMIZERS
(HR. 1785, S. 219)**

BACKGROUND

The Standard Deduction

According to the country's charitable organizations, they are one of the principal casualties of recent attempts to simplify the tax code by encouraging the use of the standard deduction. When a taxpayer chooses this option, he loses the right to itemize charitable, medical, mortgage interest and other deductions, in return for what is, in effect, an extra personal exemption. As a consequence of this decision, his tax bill is unaffected by any increase or decrease in his contributions.

The Treasury has favored wider use of the standard deduction primarily because it reduces IRS scrutiny costs; and it is clear that many taxpayers prefer the simplicity of the short form, even if they could save a little tax by itemizing. In the case of low-income taxpayers without heavy mortgage or medical costs, the standard deduction allows these households to reduce their taxable income by a greater amount than if they itemized. The option is thus particularly attractive to this group.

When a taxpayer takes the standard deduction, he receives no tax break for any charitable contributions he makes. If he gives \$100 to his church or local college he cannot deduct any part of the gift from his taxable income. Thus, the cost of the gift to him is \$100. If, on the other hand, he were to itemize and was in the 40 percent tax bracket, the deductible gift would involve a net cost to him of only \$60.

The voluntary organizations claim that the growing use of the standard deduction is a major disincentive to charitable giving, particularly by low and middle income households. Since 1970, the proportion of taxpayers using the short form has grown

from just over 50 percent to about 70 percent. Between 1970 and 1977, the charitable sector estimates that philanthropic organizations lost \$5 billion in contributions because of the tax disincentive. In 1977 alone, it is claimed, the loss amounted to approximately \$1.4 billion, almost half of which was attributable to the increased standard deduction enacted as part of the Tax Reduction and Simplification Act.¹ In addition to these losses, the charitable sector estimates that for each dollar lost as a monetary contribution, another dollar of value is lost in voluntary services generated as a result of contributions.

Use of the standard deduction is heavily concentrated among lower income taxpayers. The Joint Committee on Taxation estimates that 97.9 percent of 1979 taxpayers with incomes below \$5,000 will take the deduction, and of those with incomes of \$10,000 to \$15,000 the proportion will still be 77.3 percent. On the other hand, only 9 percent of those in the \$50,000 to \$100,000 bracket are not expected to itemize.² This means that the tax advantage of giving to charity is largely confined to taxpayers with well above average incomes. The voluntary sector finds this extremely disturbing - irrespective of the loss of income involved. Charities are concerned that the charitable deduction may be seen increasingly as just a tax loophole for the rich. The fear is that pressure might develop to revoke the deduction and that government agencies would then fund and carry out services previously supplied by the voluntary sector. Already about 30 percent of the income of American charitable institutions is provided by government.

The European Lesson

Western Europe provides a stark example of how private philanthropy can be damaged by the public's belief that it is the plaything of the rich. As David Roderick of the United Way testified before the taxation subcommittee of the Senate Finance Committee:

From 1962 to 1964 my family and I lived in France. I am dismayed about the fate of private charities in that country and other Western European nations. The people there have come to view charity as the responsibility of government and government alone. Donations by wealthy individuals or foundations, no matter how altruistic the motivation, are seen as elitist and self-serving. In many

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1. Congressional Record, p. E286, Extension of Remarks by Representative Barber Conable, January 31, 1979. In 1977 individuals contributed \$29.5 billion to philanthropic organizations, including churches.
 2. Joint Committee on Taxation, Description of S. 219, Relating To The Deduction For Charitable Contributions (USGPO, 1980), p. 13.

cases contributions for worthy purposes are simply not accepted or argued over for years.³

Popular feeling against private philanthropy is probably strongest in Sweden, where charitable donations are not deductible. The situation there has been described by Lars Berstig, information secretary at the Budget Ministry:

In the past, philanthropy was an important substitute for social benefits for the poor.... All political parties now believe that philanthropy should be a function of the state and local communities. And the mentality of Swedes today is that if you need money for disease research or support for the arts you go straight to the government.⁴

Even in Britain, where charities were the engine of social advance in Victorian and Edwardian times, philanthropy is in decline. Sixty percent of the support for charitable activities now comes from government sources. Donors in Britain receive no direct tax break for contributions. The only benefit occurs when a contributor pledges, under covenant, to give on an annual basis for at least seven years: then the recipient organization can claim a grant from the Treasury equal to the lowest rate of income tax that applies to the sum. The donor, however, enjoys no tax deduction.

This system discourages charitable contributions. Individual donations to the arts, for example, now account for less than 1 percent of total patronage, and the stringent tax laws affecting art patrons are the principal cause of the massive outflow of works of art from Britain. Potential donors receive few tax advantages for contributions, and galleries are so under-supported that they cannot compete with foreign buyers at auctions. A report on philanthropy, prepared by one of the country's leading banks, explains the resultant change in British attitudes:

In recent years there has been increasing political interest in charities, and their attractive, tax-sheltered status must have played a role in this. Some charities such as private schools or hospitals are seen as havens of wealthy privilege that enable the rich to buy services at a cut price.⁵

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3. Testimony by David Roderick, member of the Board of Governors, United Way of America, before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee, January 31, 1979.
 4. Quoted in Jonathan Kandell, "Private Charity Going Out of Style in Western Europe's Welfare States," New York Times, July 2, 1978.
 5. Ibid.

The voluntary sector in America is anxious to avoid a similar climate of opinion developing here. Charities argue that the simplification of the tax code may, inadvertently, bring this about by discouraging small donors from contributing to private organizations, thereby reserving the tax breaks for the rich.

H.R. 1785, S. 219

History

A version of the present bill was introduced in 1978, as H.R. 11183 in the House and S. 3111 in the Senate. It arose from a recommendation by the Commission on Private Philanthropy and Public Needs (the Filer Commission), which had reported in 1975. Although the proposal received wide support and was adopted by the House Ways and Means Committee as an amendment to the 1978 Revenue Act, it was not included in the final measure.

The current bill, like its predecessor, was introduced in the House by Representatives Fisher and Conable in February 1979 (H.R. 1785), and in the Senate by Senators Moynihan and Packwood in January of the same year (S. 219). So far, the bill has 130 co-sponsors in the House and 30 in the Senate. Hearings on the bill took place in January 1980 before the Subcommittee on Taxation and Debt Management of the Senate Finance Committee.

Supporters of the bill do not expect the proposal to advance as an independent bill. They see it instead as an amendment to the next general tax bill.

Provisions of the Bill

Under existing law, a deduction from taxable income is allowed for certain charitable contributions made by individuals and corporations. In the case of individual taxpayers, charitable donations are allowed as an itemized deduction from adjusted gross income (AGI) in arriving at taxable income. If the taxpayer takes the standard deduction charitable contributions cannot, of course, be taken as an additional deduction. In addition, existing law treats an individual's contributions as an item of tax preference for the purposes of alternative minimum tax and maximum tax.

The bill would alter the code as follows:

a) Above-the Line Deductions

The deduction for charitable contributions would be extended to all taxpayers by allowing donations to be claimed as an above-the-line deduction from gross income in arriving at AGI. Thus, a taxpayer would obtain a tax break from charitable contributions he made whether or not he itemized.

b) Calculation of Deduction Floors and Limits

In calculating the limit of deductible charitable contributions as a percentage of AGI, AGI would continue to be assessed without regard to the deduction. Similarly, in calculating the floor of 3 percent of AGI for the medical expenses deduction, and the 1 percent floor for medicines and drugs, AGI would be determined without regard to the above-the-line charitable contributions deduction. This provision would mean that the floor for these deductions would be unaffected by the level of donations.

c) Alternative Minimum and Maximum Tax

Existing law includes charitable contributions as a tax preference for the calculation of alternative minimum tax. The alternative minimum tax applies to an individual's gross income reduced by deductions allowed for the year, together with accumulated distributions from trusts, and increased by two tax preferences. These preferences are the capital gains deduction and the adjusted itemized deductions, including charitable contributions, insofar as these exceed 60 percent of the taxpayer's AGI. In the case of the maximum tax applicable to income from personal services, the taxable income is reduced by the individual's tax preference items, including charitable contributions.

The bill would remove charitable contributions as a determinant of tax preference items for the purposes of assessing maximum or minimum tax.

Effects of the Bill

The supporters of the bill claim that it would have the following beneficial effects.

a) Low Income Earners

By allowing non-itemizers to take an above-the-line deduction all taxpayers would obtain a tax benefit from making charitable donations. The bill's advocates argue that this would have the effect of restoring the incentive to give by low income earners that has been eroded by the widening use of the short form, and prevent the situation developing where philanthropy appears to be merely a tax loophole for the rich.

b) Induced Giving

Even if the bill did not lead to an increase in charitable giving, many feel it would be justified from the point of view of fairness. But supporters of the bill also contend that cost-benefit considerations warrant passage of the measure.

The argument put forward is that the price of elasticity of giving is still greater than 1 for low income households.⁶ If the price elasticity were precisely 1, the loss in tax revenue resulting from the bill would be matched exactly by extra giving to charity. For any elasticity greater than 1 the induced giving would exceed the tax loss to the Treasury. Thus, the revenue loss due to the bill, according to its supporters, would be more than covered by extra donations due to the effect of a drop in the "price" of giving for about 70 percent of taxpayers.

Professor Martin Feldstein of Harvard University has conducted several studies have been conducted to derive the price elasticity for charitable giving.⁷ Using various types of data, Feldstein has estimated that the price elasticity for American taxpayers is in the range 1.0 to 1.4.⁸ One of the studies attempted to assess the elasticity for lower and lower-middle income taxpayers, using survey information which included non-itemizers as well as itemizers. Feldstein found that the price elasticity for this group was also greater than 1 and may have been closer to 2, indicating that the bill would lead to an increase in giving substantially greater than the tax loss to the Treasury.

TREASURY OBJECTIONS TO THE BILL

S. 219 and H.R. 1785 are opposed by the Administration. In testimony on the bill before the Senate, Treasury officials made the following criticisms.

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6. For a taxpayer with a marginal rate of tax who itemizes his deductions, the "price" of giving a \$1 contribution to charity is actually $(1-t) \times \$1$. For a non-itemizer the cost is \$1. The bill would make the price $(1-t) \times \$1$ for all taxpayers.

The price elasticity of charitable giving is the percentage increase in charitable giving per percentage point decrease in the price of giving. Thus, if a non-itemizer is in the 40 percent bracket the bill would have the effect of decreasing the price of his gift by 40 percent. If this caused him to increase his giving by 40 percent the elasticity would be 1.0. If no extra giving occurred the elasticity would be 0. If his contributions increased by 80 percent the elasticity would be 2.0.

7. Feldstein, "The Income Tax and Charitable Contributions," National Tax Journal, 1975; (with Charles Clotfelter), "Tax Incentives and Charitable Contributions in the United States," Journal of Public Economics, 1976; (with Amy Taylor), "The Income Tax and Charitable Contributions," Economica, 1976; (with Michael Boskin), "Effects of the Charitable Deduction on Contributions by Low-Income and Middle-Income Households," Review of Economics and Statistics, 1977.
8. For a summary of Feldstein's findings, see his testimony before the Subcommittee on Taxation of the Senate Finance Committee, January 31, 1980.
9. Feldstein and Boskin, "Effects of the Charitable Deduction."

a) Cost

The Treasury contends that the bill would involve at least a \$3 billion loss in tax revenue, assuming existing patterns of giving. If an increase in contributions were to be induced by the measure, the tax loss would be even greater. In view of the Administration's strategy of controlling and balancing the federal budget, a reduction in revenue would force even deeper cuts in federal services to maintain targets. The Treasury also argues that although the bill would mean a \$2.5 billion tax saving for non-itemizers, who might be induced to give more, it would also lead to a \$0.5 billion "windfall" gain for the 3 million current itemizers who would find it advantageous to take the standard deduction while maintaining the same level of contributions.

Comment

Although the bill would reduce tax revenue, it would also have some effect on budget demands. About 40 percent of charitable contributions are allocated to health, welfare, or educational organizations (most of the remainder goes to churches). Private contributions to such activities relieve pressure on the government to provide services. If the price elasticity of donations is in the region of 1.4, as Feldstein estimates, then the tax revenue loss resulting from the bill would be closely matched by an increase in giving to health, education and welfare organizations. So budget cuts could be made without any serious impact on services: the net effect would be a shift in support from government sources to private sources.

There is almost always some "windfall" gain (as the Treasury puts it) to someone as a result of virtually any tax law change. But it seems rather unreasonable for the Administration to complain in view of the fact that pressure for the bill arose because of the Treasury's policy of simplifying tax-gathering procedures (resulting in a windfall saving to the IRS).

b) Induced Giving

A central claim of the bill's supporters is that more charitable deduction for non-itemizers would induce more giving by low income taxpayers. The Treasury disputes this claim.

First, argues the Treasury, the evidence that the price elasticity of giving for low income households is greater than 1 is highly questionable. Citing the work of Charles Clodfelter, Treasury staff point out that the lack of clear tax data for non-itemizers makes the estimation of elasticity imprecise.¹⁰

10. See Charles Clodfelter and Eugene Steuerle, "The Effects of the Federal Income Tax on Charitable Giving," in Henry J. Aaron and Joseph A. Pechman (eds.), Responses to Changes in Taxation (Washington, D.C.: Brookings Institution, forthcoming). See also testimony by Clodfelter before the Subcommittee on Taxation of the Senate Finance Committee, January 31, 1980.

The Treasury does concede that at each income level itemizers tend to give substantially more to charity than non-itemizers, but spokesmen argue that this is due to an "itemization effect" and not a price effect. It is not that people who itemize give more because of the tax saving, but rather that people who intend to give more in any case simply itemize to obtain a tax benefit. Thus, contends the Treasury, the tax deduction does not necessarily induce them to give more. In support of this thesis, the Treasury cites its own studies which indicate that high wealth and investment income (as opposed to high personal service income) tends to be associated with large charitable contributions. Those with large investments and property assets generally itemize in any case, because of the nature of their income and expenses. The same would not be true of low income earners, and so it could not be assumed that allowing this group a deduction would lead to more giving.

Comment

For the most part the Treasury argument can only be tested on the basis of empirical evidence, and this in itself will be influenced by the assumptions made regarding donor behavior. Martin Feldstein addressed this issue in his testimony before the Senate. He pointed out that the National Bureau of Economic Research (NBER) has been developing a model to calculate the impact of tax changes on various magnitudes, including charitable giving. The NBER model is specifically designed to measure the price responsiveness of taxpayers, said Feldstein, which the Treasury studies do not. As yet the project is at an early stage, but full figures will be available soon.¹¹

Feldstein and Boskin's study of low and lower-middle income groups did attempt to detect differences in giving patterns between itemizers and non-itemizers, and sought also to test the "itemization effect" hypothesis.¹² The results of their study indicate that such an effect is very small, and that the price effect is the major influence, leading to a price elasticity of greater than 1, in line with the claims of the bill's supporters.¹³

c) Complexity

According to the Treasury, the bill would cause the 1040 and 1040A to be excessively complicated. Not only would an extra line need to be included, but itemizers would have to add back the amount of charitable contributions to derive AGI for the

11. Testimony delivered on January 31, 1980.

12. Feldstein and Boskin, "Effects of the Charitable Deduction."

13. For a critical analysis of the Feldstein and Boskin findings, see Clotfelter and Steuerle, "Effects of the Federal Income Tax."

purposes of the medical and other deductions. The Treasury claims that:

This add-back would be difficult for itemizers to understand and accept and may be expected to lead to considerable taxpayer complaint and confusion.¹⁴

Treasury spokesmen also argue that the bill would pose severe administrative problems. The IRS finds the existing charitable contributions the most troublesome to monitor, especially in the case of low income taxpayers. Often very small amounts are given to numerous organizations, and proper receipts are lacking. IRS audit records show that a downward adjustment occurs in about 40 percent of returns from taxpayers with incomes below \$10,000. If the bill were enacted, the Treasury argues, the IRS would be faced with prohibitive auditing costs for small donors with low tax brackets. Because of this, officials argue, the supposed cost-benefit gain on the bill would be lost.

Comment

Given the existing deductions available to itemizers, such as mortgage interest, medical expenses, state and local taxes, gasoline tax, casualty and theft losses, gambling losses, woodburning stove allowances, etc., it seems unlikely that an above-the-line charity deduction would stretch the comprehension of taxpayers beyond breaking point. Nor does it seem probable that the computation of AGI for the purposes of calculating floors and ceilings for certain itemized deductions would be any serious problem.

The issue of IRS scrutiny costs does warrant more serious consideration, however, since high auditing expenses could undermine the claim that the bill would generate more in gifts than would be lost in revenue. Of course, the intent of the bill is not aimed at saving the IRS work. But if the auditing cost is such a serious problem, say supporters of the bill, a floor of \$100 or some other minimum amount might be instituted before an above-the-line deduction could be taken. This compromise was suggested at the Senate hearing on the bill, and the Treasury spokesman, while reserving the Administration's position on the bill, did agree that a floor would remove most of the objections regarding the cost of auditing.

CONCLUSION

Arguments for the bill fall into two broad categories. There are political considerations, chief among which is the

14. For the Treasury analysis of the bill see the statement of Assistant Secretary Donald Lubick before the Subcommittee on Taxation of the Senate Finance Committee, January 30, 1980.

encouragement of charitable giving among lower and middle income households, in order to avoid a situation where philanthropy is undertaken only by an affluent minority who enjoy a tax benefit for their contributions, since this could lead to an erosion of support for private charity. Such a situation could also hasten the replacement of the private sector by government agencies, a trend which supporters of the bill oppose.

The second set of considerations are economic. Would the bill actually lead to more money being donated to charity, or would it lead only to a loss of tax revenue? So far the balance of evidence suggests that giving would increase as a result of the bill, and probably by an amount exceeding the tax loss. But the figures are not universally accepted, and until more precise studies on low income households are completed the estimates of the bill's effects will remain in some dispute. It should be noted, however, that the value of the bill does not depend solely on the stimulus it might provide to philanthropy. The preservation of a strong, independent private sector might be thought a sufficient justification for the bill.

The measure has a great deal of support both within the Congress and elsewhere. The voluntary sector is pressing strongly for its passage, and a bill of this sort was recommended by the Filer Commission in its exhaustive study of American philanthropy.¹⁵ A recent poll commissioned by The Heritage Foundation also found that over 70 percent of the public agrees with the proposal.¹⁶ With this range and depth of support, the bill will probably be an important aspect of debate when the next general tax bill comes under consideration.

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15. Commission on Private Philanthropy and Public Needs, Giving in America (Washington, D.C.: The Commission, 1975), p. 135.
 16. Stuart M. Butler, Philanthropy in America: The Need for Action (Washington, D.C.: The Heritage Foundation, 1980), p. 40.